Corporate Governance: New Challenges and Opportunities

The UK

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Overview

Understanding 21st century corporate governance is a crucial task for academics, practitioners and policymakers alike. In the post-financial crisis context, this chapter elaborates on the current developments in the UK corporate governance, outlining the key challenges as well as opportunities. The chapter begins with an account of the evolution of UK ownership and corporate control, providing a brief description of ownership structures and the legal framework. The emergence of a new class of institutional investor-owners such as pension funds, insurance companies, endowment funds and other asset managers is noted, alongside their increasing significance within academic and policy debates in the UK. The chapter then elaborates on the development of corporate governance codes, which place more emphasis on greater accountability and stewardship both inside and outside the corporate boardroom. The chapter proceeds with an overview of board practices, director remuneration and corporate performance. This is followed by a discussion of mixed evidence on shareholder engagement. The chapter concludes by reflecting on the challenges of UK corporate governance, offering a view on future opportunities.

Overview of the UK ownership and control patterns

The debates about corporate governance have a longstanding history, with the first mentioning of a phrase 'corporate governance' appearing in use in the 1980s, which was quickly adopted worldwide (Tricker, 2015). The wider debate on corporate governance and the observation that the modern corporation is characterized by a separation of ownership from control (Berle and Means, 1932), which presumes that the functions of management and ownership are typically held by separate constituents: ownership in the form of equity being dispersed among a large number of shareowners, whilst day-to-day control of the corporation is delegated to professional managers acting as executives for the corporation. Associated with this separation is a corporate governance problem, whereby managers do not share shareholders' interests. Jensen and Meckling (1976) and Fama and Jensen (1983) define this as an agency problem. Jensen and Meckling (1976) define an agency relationship as:

> *'…a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal' (p. 308).*

Within corporate governance, the agency problem arises when the same agents manage and control important decisions within a firm (Fama and Jensen, 1983). Information asymmetry in this case means that incumbent managers are in a position to pursue their own objectives, such as increasing corporate size, at the expense of the shareholder interests, for example, the value of the company. Agency costs are therefore incurred as a result of a need to monitor and control agents who otherwise might act in their own interests, rather than those of principals (Fama and Jensen, 1983).

Following the agency perspective, a principal concern of corporate governance is to employ governance mechanisms that resolve or minimize a conflict of interests between managers and shareholders. A significant body of theoretical and empirical literature about corporate governance exists on the principal-agent relationships, proposing several hypotheses about various governance mechanisms to minimize agency costs. One way of differentiating between governance mechanisms is to refer to them as internal (incentives and monitoring) governance mechanisms and external (monitoring and disciplinary) mechanisms. Internal mechanisms include managerial share ownership (Jensen and Meckling, 1976) and oversight by a board of directors (Fama, 1980; Fama and Jensen, 1983; Baysinger and Butler, 1985). The external mechanisms include managerial labour markets (Fama, 1980), the existence of large external shareholders (Shleifer and Vishny, 1986), mergers, buyouts and takeovers (Hirschey, 1986), as well as the market for corporate control, which acts as a mechanism of last resort (Jensen, 1986; Grossman and Hart, 1987).

The literature on the evolution of corporate ownership is voluminous,[1] but one of the well-established facts about corporate ownership is that ownership of large listed companies is dispersed in the UK and US and concentrated in most other countries (Franks, Mayer and Rossi, 2005). In the UK, even in the absence of strong investor protection rights dispersed ownership has emerged rapidly in the first half of the 20th century. The separation of ownership from control and the shift to 'managerial capitalism' (Aguilera, et. al., 2006) encouraged ownership diversification to the point where most shareholders only held small stakes within companies. This created a more dispersed share ownership within the Anglo-Saxon system of corporate governance (Mayer, 2000). The changed pattern of share ownership in the UK and US has over the past 30 years led to a greater concentration of ownership in the hands of institutional investors such as insurance companies and pension funds (Mallin, et. al., 2005). According to Mallin (2008), institutional investors such as insurance companies, pension funds, banks, unit and investment trusts and other financial institutions own approximately 45% of UK equities, with overseas institutional investors owning 40% and individuals owning only 13% of UK equity [Is this all companies, or just the Top 100/250/500?]. Pension funds held nearly 13% of total UK equity in 2006, exceeded only by insurance companies, which owned nearly 15% (Mallin, 2008).

By 2015, out of £6.6 trillion of assets under management in the UK, approximately £2.1 trillion were invested through pension funds, £1.2 trillion were in retail investment products and £0.4 trillion in public sector and charity investments. There is a further £1 trillion investment in insurance products and £1 trillion invested in non-mainstream asset management products, which include pension fund investments (FCA, 2016). In 2010, UK pension funds invested around 43% of their

[1] For an overview see J.F. Wilson (1995) *British Business History, 1720-1994* (Manchester, 1995). For thorough surveys of historical trends influencing the development of Britain's current system of corporate governance see Cheffins B. (2001). 'Law, Economics and the UK's System of Corporate Governance: Lessons from History', *Journal of Corporate Law Studies,* 71 and Cheffins, B. (2004). 'Mergers and the Evolution of Patterns of Corporate Ownership and Control: The British Experience', Business History, Vol. 46, No. 2, pp.256-284. For a political and historical account of corporate governance see Mar Roe (2004). 'Institutions of Corporate Governance' in Menard, C and Shirley, M, eds., *Handbook for New Institutional Economics*' (Norwell MA: Kluwer Academic Publishers).

assets in UK equities, a figure that amounted to nearly £400 billion (The Purple Book, 2010).

Legislation, Regulation and Corporate Governance Codes

The traditional form of the limited liability company has been created in law and therefore limited liability companies depend on company law for their existence, continuity and winding up (Tricker, 2015). UK company law and particularly the Companies Act 2006 defines the way in which the companies are incorporated, how their directors are appointed, how the company information is being disclosed and reported and how shareholder relations are being handled (Tricker, 2015). In the United Kingdom and in Commonwealth countries the corporate governance model is 'principles based', which means that the codes of good governance practice determine board responsibilities, not the rule of law. In this model, UK companies are required to report on how they have followed the best practice codes and explain why they have not – a so-called 'comply or explain' model.

Following corporate scandals such as Mirror Group/Maxwell, Polly Peck, Queen's Moat House Hotels and Ferranti, the UK produced the world's first corporate governance report in 1992, which contained a formal corporate governance code. The Committee on Financial Aspects of Corporate Governance, also known as the Cadbury Committee, was set up in May 1991 to address the increasingly voiced concerns about the conduct of UK companies and how they dealt with financial reporting, accountability and the wider implications of these issues. The Committee was sponsored by the London Stock Exchange (LSE), the Financial Reporting Council (FRC) and the accountancy profession. It produced a draft Report in May 1992 and, after further consultation, published its final Report and recommendations in December 1992. The Cadbury Report played a crucial role in influencing thinking about corporate governance around the world. The Report had identified 'corporate governance' as 'the system by which the companies are directed and controlled. Boards of directors are responsible for the governance of their companies'. Subsequently, the UK has published more corporate governance reports than any other country.

The governance reports that followed[2] focused on preventing the potential abuse of corporate power and called for greater accountability, compliance and independence at board level, the separation of the role of chairman of the board from that of chief executive, as well as more effective participation by non-executive directors on boards. Table 1 gives a chronological summary of the key UK governance reports.

Table 1 UK Corporate Governance Reports

Report	Description
The Cadbury Report 1992	A discretionary 'comply or explain' code which called for:

[2] For an overview of the development of UK corporate governance codes see Nordberg and McNulty (2013). 'Creating better boards through codification: Possibilities and limitations in UK corporate governance, 1992-2010', *Business History*, 55:3, 348-374.

	- the wider use of independent non-executive directors (NED) - the introduction of an audit committee of the board with a minimum of three independent NEDs - the division of responsibilities between the Board Chairman and the Chief Executive - the use of the remuneration committee within the board to oversee executive rewards - the introduction of the nomination committee with independent director to oversee the appointment of the new board members - adherence to a detailed code of best practice
The Greenbury Report 1995	Focused on the issues of director's remuneration recommending that: - the remuneration committees consisted solely of independent non-executive directors - the chairman of the remuneration committee should respond to shareholder's questions at the AGM - annual reports should include details of all director rewards – naming each director - director's contracts should run no more than 1 year to avoid excessive golden handshakes - share options schemes for directors should be linked to long-term corporate performance
The Hampel Report 1998	A review of the progress made after the first two reports. The report argued that: - good governance needs broad principles, not prescriptive rules - compliance with sound governance practices should be flexible and relevant to each company's individual circumstances - governance should not be reduced to a 'box-ticking' exercise - the unitary board structure is totally accepted and there is no interest in the alternative governance structures (e.g two tier structures) - the board is accountable to the company's shareholders (no case to include other stakeholder groups) - self-regulation is the preferred approach to corporate governance with no need for more company legislation
The UK Combined Code 1998	Consolidated previous codes and was incorporated into the London Stock Exchange's listing rules. The code set out standards of best practice on board composition, director remuneration, accountability and audit in relation to shareholders. The code was accepted on the 'comply or explain' basis for all the companies that were incorporated in the UK.
The Turnbull Report 1999/2005	Elaborated on the internal controls of the companies, including financial, operational, compliance and risk management. The report recognized that risk assessment was vital, recommending that internal controls analysis was a vital part of corporate governance process.
The Myners Report 2001	Focused on addressing the responsibilities of institutional investors. The report suggested that: 'Good governance is essential to all forms of business. It provides checks and balances that ensures that firms are run efficiently and meet the objectives of their owners, whether shareholders or the members of a life mutual. It also has limitations…risk is inherent in the conduct of business…The recommendations aim to achieve grater accountability by life mutuals to their members…This includes measures …promoting better internal scrutiny of management by firm's boards as well as the role of the Financial Services Authority (FSA), the UK's financial regulatory body.
The Higgs Report 2003	Focused on the effectiveness of the Non-Executive Directors and sharpened the requirements in the previous codes, recommending that: - at least half of the board should comprise of independent NEDs - all members of the audit and remuneration committees and a majority of the members of the nomination committees should be independent NEDs

	- the role of Chairman should always be separate from the Chief Executive - director recruitment should be rigorous, formal and transparent - executive directors should not hold more than one NED role of a FTSE100 company - boards should evaluate director performance and board committees annually and have a comprehensive induction programme - boards should have a senior NED to liaise with shareholders
The Smith Report 2003	Focused on the work of the audit committees and called for: - a strengthening for the role of the audit committee - all members of the audit committee to be independent - at least one member of the committee to have significant, recent and relevant financial experience - the audit committee should recommend the selection of the external auditor - the audit committee report should be included in the annual report to shareholders - the chairman of the audit committee should attend the AGM to answer shareholder's questions
The Tyson Report 2003	Focused on recruitment and development of NEDs, calling for: - more professionalism and transparency in the recruitment of directors - the introduction of director induction and training - the use of wider catchment area for outside directors
The (revised) UK Combined Code 2003/2006	Produces a more detailed list of broad corporate governance requirements grouped under four headings: - independence - diligence - professional development - board performance evaluation
Turner Review 2009	Focused on banking sector remuneration and compensation incentives
UK Corporate Governance Code 2010/2012	Following the Financial Crisis the Financial Reporting Council (FRC) has reviewed the UK Combined Code and updated the Code to contain broad principles around: - Leadership - Effectiveness - Accountability - Remuneration - Relations with Shareholders

Adapted from Tricker (2015)

Notwithstanding the significance of the Cadbury Report, as well as the reports that followed, many critics have argued that all these reports did not go far enough to improve corporate governance practices by simply introducing a 'comply or explain' culture. For example, Tilba (2015) suggests that the narrative around Cadbury was framed mostly in terms of resolving the issues arising between shareholders and boards, excluding, for example, employees. Nordberg and McNulty (2013) and Stewart and McNulty (2015) also observe a shifting discourse in the codification within UK corporate governance away from board structures, composition and procedures in Cadbury towards 'behaviour', as the codes seek to improve board effectiveness as a mechanism of governance. The revised version of the Code now explicates that compliance is not enough; what is also important is the substance of compliance, which is context-specific and involves the behaviour of actors both in and around boards.

The emergence of institutional investors such as insurance companies and pension funds, as well as the arrival of non-traditional investors such as hedge funds and investors outside the UK have also altered the character of the codes. Greater attention is now being given to the role that institutional investors *ought* to perform in corporate governance (Mallin, 2008), highlighting the degree of disengagement currently pursued by these bodies. Following governance scandals relating to Enron in 2001 and leading up to the collapse of Lehman Brothers in 2008, a number of 'voluntary' codes have prescribed greater investor monitoring and engagement vis-à-vis investee companies. By 2006, the Combined Code on Corporate Governance was requiring institutional investors to make considered use of their votes; enter into a dialogue with investee companies based on the mutual understanding of objectives; and give due consideration to all relevant factors drawn to their attention when evaluating corporate governance arrangements of their investee companies. Similar requirements have been published by the ISC's Responsibilities of Institutional Shareholders and Agents: Statements of Principles (Institutional Shareholders' Committee, 2007). In the UK the financial crisis has served to heighten the expectations of policy-makers that institutional investors should act as stewards and engaged owners of shares (Ownership Commission, 2012; The Stewardship Code, 2010).

A year-long review by John Kay of UK equity markets (2012) was especially critical of investment short-termism and a lack of investor ownership behaviour. The Kay Review emphasized the need for a shift towards long-term and fiduciary standards, necessitating loyalty and prudence within the investment world. This also prompted the UK Law Commissions' inquiry into fiduciary duties of investment intermediaries, resulting in a report (2014) that defines stewardship activities as including the monitoring of and engaging with companies on matters such as strategy, performance, risk, capital structure and corporate governance, including culture and remuneration. In November 2015, the Financial Conduct Authority launched an Asset Management Market Study in order to to understand whether competition within the capital market is working effectively to enable both institutional and retail investors to generate value for money when purchasing asset management services.

Board of Director Practices

Fama and Jensen (1983) consider the board of directors to be the most central governance mechanism. They argue that managerial opportunism can be countered by a board of directors exercising decision control and subsequent oversight of management. The importance and prominence afforded to boards is also visible in the development of the corporate governance reforms, starting with the Cadbury Committee (1992), continuing with the Higgs Review (2003) and most recently culminating in the revised UK Code of Corporate Governance (2012).

Within UK unitary board structure corporate directors have two fundamental duties: a duty of trust and a duty of care. A duty of trust assumes the exercise of fiduciary responsibility to the shareholders. This includes acting in good faith in the interests of the company as a whole; not acting for an improper purpose; avoiding conflicts of interest; not making an improper use of position and information; not trading wile insolvent. A duty of care assumes making decisions with reasonable care and due diligence (Tricker, 2015). Boards of Directors are thus entrusted to exercise critical evaluative judgement at the top of the corporate hierarchy. The board is usually tasked with: determining the company aims, strategic direction; establishing policies to achieve those aims; and monitoring progress in the achievement of those aims (Mallin, 2016). Table 3 summarises key roles within the UK unitary board.

Table 3 Board Roles, Responsibilities and Subcommittees

Role	Responsibility
Chief Executive Officer (CEO)	Responsible for the running of the company's' business should be separate from Board Chairman to avoid power concentration in one individual
Charmin	Responsible for running the board; making sure that the board meets frequently; that all directors have access to the information they need to make an informed contribution at board meetings; and that all directors have an opportunity to speak at board meetings.
Senior Independent Director (SID)	Typically selected from the independent non-executive directors on the board. Company shareholders have the right to contact a SID if their concerns cannot be addressed by other senior members of the board.
Non-Executive Director (NED)	Counterweight to executive directors in order to ensure that the individuals or a group of individuals cannot unduly influence board decisions. Independence is also a key characteristic within this role.
Company Secretary	Responsible for facilitating board activities, for example, by providing adequate and timely information ahead of board meetings. Also provides advice on all governance matters. Must act in good faith and avid conflicts of interest.
Audit Committee	The most important committee, which is independent of the executive and whose remit is to protect the interests of shareholders in relation to financial reporting and internal controls. Should comprise of independent non –executive directors who are in a position to ask appropriate questions and challenge where necessary.
Remuneration Committee	Responsible for making recommendations to the board on the company's framework of executive remuneration and its cost. Could determine specific remuneration packages for each of the executive directors including pensions arrangements and any compensation.
Nomination Committee	Leading a rigorous process of board appointments comprised of independent non-executive directors. Responsible for evaluating the existing balance of skills, knowledge and experience on the board, utilizing this profile when preparing a candidate profile for a new appointment. Should also be involved in succession planning.
Risk Committee	Ensuring that internal mechanisms of control and risk management systems are working effectively and efficiently.
Ethics Committee	Following collapse of Enron more companies have introduced ethics sub-committees to ensure that there is a strong organizational ethic by cascading an ethics code through the company.

Adapted from Mallin (2016)

Ultimately, the board has three key functions: management, oversight and service. The lines between these functions are fuzzy at best and overtime there has been a shift from boards having an advisory role in the 1970s to a more managerial role in the 1990s, with an increasing emphasis on the monitoring role and director independence in the context of persisting corporate scandals and failures in the 2000s (Bainbridge, 2012). In short, the focus on director independence has resulted in a culture of avoiding conflicts of interest at the expense of competence.

Director Remuneration and Corporate Performance

Directors' remuneration practices have always been a focus of attention for policy makers, media and academics alike. Excessive bonus packages, share options and other financial perks, which in many cases have a very weak or no link to corporate performance, as well as persisting and spectacular corporate collapses, have created conditions of mistrust, particularly within the UK's financial sector. Mallin (2016) characterizes the debate around director remuneration as long-standing and tending to focus around four key areas: the overall level of director's remuneration and the role of share-option; the suitability of performance measures linking director's remuneration with performance; the role played by the remuneration committee in the setting of director's remuneration; and the influence that shareholders can exercise on directors' pay.

Within the UK, the use of corporate share options as long-term contracts has been a common incentive device for senior executives. Other elements of directors' remuneration include base salary, bonuses, restricted share plans, pension and other benefits like cars and healthcare (Mallin, 2016). The accompanying public perception of directors' remuneration and other incentive packages being too generous and at the expense of rewarding shareholders has been ever present in those debates. It is also worth noting, however, that remuneration packages in the States have been much higher than in the UK (Mallin, 2016). Bebchuk and Fried (2004) identify serious flaws in remuneration arrangements which 'have hurt shareholders both by increasing pay levels and, even more important, by leading to practices that dilute and distort manager's incentives'. The recent financial crisis and corporate failures serve only to emphasize the inadequacy of the current reward and incentive systems in the UK which are not supported by strong corporate performance.

In the context of the UK banking crisis, the Turner Review (2009) reported that executive compensation incentives encouraged executives and traders to take on excessive investment risks. The report also highlighted the short-term nature of executive remuneration incentives which come at the expense of long-term sustainability and value for shareholders. A key recommendation that the Report made was to incorporate risk-taking within executive and senior management remuneration packages. Mallin (2016) cites the response of the House of Commons Treasury Committee on the banking crisis, governance and pay structures in the City by stating that:

> *'Whilst the causes of the present financial crisis are numerous and diverse, it is clear that bonus-driven remuneration structures prevalent in the City of London as well as in other financial centres, especially in investment banking, led to reckless and excessive risk-taking in too many cases the design of bonus schemes in the banking sector were flawed and not aligned with the interests of shareholders and the long-trm sustainability of banks'.*

The UK government committee was also very critical of the Financial Services Authority (presently Financial Conduct Authority) arguing that the Turner Review has downplayed the role that directors' incentives played in the banking crisis, placing more emphasis on reforming remuneration structures and the unhealthy bonus culture. The government response to the Report also suggested strengthening the links between risk, remuneration and audit committees. Within the subsequent review of the efficiency of UK equity markets, Sir David Walker (2009) also looked very closely at remuneration, recommending more disclosure, creating a code of conduct for remuneration consultants, and recommending that executive pay should be more closely aligned to corporate performance. The revised UK Corporate Governance Code 2010 did include a number of Walker's recommendations and importantly a recommendation about performance-related pay being more aligned to the long-term interests of the company and into its internal risk mechanisms. Notwithstanding progress made in executive pay codes of best practice, however, there is still great disparity between executive pay and employees of UK largest companies where CEO compensation bears little relationship to company performance and/or shareholder returns (Mallin, 2016).

While corporate performance criteria may differ between different companies and industries, broadly it can be characterised as market-based measures; accounts-based measures; and individual-based measures. Some elements of performance can include return to shareholders; profit margins; share price and earnings per share; return on capital and individual director performance indicators (Mallin, 2016). The High Pay Commission's 2011 report has examined executive compensation in relation to corporate performance and observed that bonuses are still excessive and that salary growth is not related to key corporate performance indicators such as share earnings, market capitalisation and/or corporate profit. The High Commission's Final Report (2011) on *Cheques with Balances: why tackling high pay is in the national interest* provided a comprehensive plan based on the principles of transparency, accountability and fairness to help tackle persistent problems of the mismatch between excessive executive pay and unrelated firm performance.

The Financial Crisis of 2008 has also placed greater emphasis on institutional investor involvement in corporate governance. The subsequent UK Stewardship Code (2010) therefore encouraged instructional investors such as insurance companies, investment fund managers and pension funds to act as engaged and responsible shareowners, rather than just traders of corporate stock and be more involved in influencing governance issues such as directors' pay, board structure and strategic initiatives.

Shareholder Activism

While exploring the role of legal restrictions on institutional investor behaviour, Black and Coffee (1994) argue that the UK is an ideal setting for institutional investors to monitor and intervene in company affairs because it provides more legal tools to protect shareholders' interests. The UK common law system, which is associated with higher guarantees for shareholder protection (La Porta, et. al. 1999; 2000) and the development of codes of good governance (Shleifer and Vishny, 1997; La Porta, et. al. 2000; 1999; Aguilera and Cuervo-Cazurra, 2004) is considered to have placed institutional investors in a position of power to hold corporate managers accountable. Bebchuk (2005) notes that 'the UK law gives shareholders…powers that enable them to have greater influence on the board than their US counterparts' (p. 849). For example, outside of Annual General Meetings (AGMs) shareholders in the UK can call for Extraordinary General Meetings (EGMs), starting with 10% of shareholdings and put forward proposals to remove any or all board directors if more than 50% of votes support this proposition (Becht, et. al. 2009). Institutional involvement is also facilitated through organizations such as the Association of British Insurers (ABI) and National Association of Pension Funds (NAPF).

All in all, the current landscape of UK ownership, and the legal and regulatory environment of shareholder protection, are seen to create receptive conditions for investor involvement in corporate governance. However, despite the legal frameworks and certain shareholder activism developments, the evidence of investors behaving as stewards in the spirit of the codes appears more assumed than demonstrated as managerial decision making is still left to professionally trained managers and executives. The empirical evidence investigating this relationship is decidedly mixed (Bainbridge, 2003; Dalton, et. al., 2007; Tilba, 2011). Most recent academic reviews of the current state of shareholder activism literature suggest that the research on shareholder engagement offers conflicting perspectives on this topic (Goranova and Ryan, 2014; McNulty and Nordberg, 2016). On the one hand, there is much written about 'active' and engaging investors, yet on the other hand, the case is made that institutional investors tend to be 'passive' in their approach to corporations. What follows on here is discussion of the existing evidence of shareholder activism in the context of corporate governance issues such as executive remuneration, director practices, CSR and firm performance. This is then followed by a summary of the evidence of shareholder disengagement.

Shareholder Engagement

Over the years, various studies have examined how institutional investors apply the ownership principles to establish the effectiveness of such application in different areas of corporate governance. There is evidence of investor activism both in the US and Britain. The US studies of investor activism are relevant here because the corporate landscape in the UK and the US has similar dispersed share-ownership structures (Mayer, 2000) and institutional investors in both countries have been under similar pressures to act as a mechanism of accountability between senior managers, boards and shareholders. As a result of corporate governance scandals, the Sarbanes-Oxley Act in the US and The Combined Code on Corporate Governance in the UK, both share the philosophy of shareholder primacy (Armour, et. al., 2003).

Some of the well-quoted studies on investor activism explore the effects of California Public Employees Retirement System (CalPERS) activism on target firm governance structure, shareholder wealth and performance. Smith (1996) finds that shareholder wealth increases in those targeted companies who adopt changes proposed by the active investor. The analysis of announcement reactions of CalPERS focus list firms carried out by Barber (2007) finds that CalPERS' activism has created $ 3.1 billion in shareholder value. Focusing particularly on the effects of shareholder proposals, the often-quoted survey by Gillian and Starks (2000) reports that institutional investor proposals gain substantially more support from the companies. Gillian and Starks also note that shareholder activism has evolved to become an important characteristic of the financial market.

A considerable number of articles concentrate particularly on the relationship between institutional ownership and executive remuneration. A study into the effects of institutional ownership on executive pay over the period between 1992-1997 by Hartzell and Starks (2003) demonstrates that institutional investors actively influence executive compensation structures. Hartzell and Starks suggest that firms with higher institutional investor concentration have lower managerial compensations. The results of the Hartzell and Starks (2003) study also indicate that institutional investors serve a monitoring role in corporate governance. Relating to executive remuneration, a more recent survey by Watson Wyatt (2005) finds that 90% of institutional investors consider that corporate executives are overpaid. This may help explain the results of Hartzell and Starks (2003) and the Annual Corporate Governance Review by Georgeson Shareholder (2005) that observe an increase in the number of resolutions voted upon and higher numbers of proposals have achieved a majority of votes cast. The most significant increase in voting was associated with executive compensation and board related issues. Table 2 demonstrates that the voting on executive compensation increased from 51 proposals in 2001 to 133 in 2005. Board-related proposals jumped from 52 in 2001 to 109 in 2005.

Table 2 Corporate Governance Proposals, 2001-2005

Proposal Type	2001	%	2002	%	2003	%	2004	%	2005	%
Executive Compensation	51	21.2	43	15.8	179	41.9	167	40.3	133	35.5
Board Related	52	21.6	58	21.2	52	12.2	82	19.8	109	29.1
Repeal Classified Board	42	17.4	39	14.3	38	8.9	36	8.7	44	11.7
Poison Pill Rescission	21	8.7	50	18.3	76	17.8	50	12.1	23	6.1
Cumulative Voting	16	6.6	18	6.6	19	4.4	22	5.3	18	4.8
Supermajority Provision	9	3.7	10	3.7	8	1.9	7	1.7	13	3.5
Audit-Related	N/A	N/A	20	7.3	19	4.4	16	3.9	7	1.9
Other	50	20.8	35	12.8	36	8.5	34	8.2	28	7.4
Total	241	100	273	100	427	100	414	100	375	100

Source: Annual Corporate Governance Review (2005), Georgeson Shareholder

More general conclusions about the significance of the role of institutional investors in financial markets and corporate governance are drawn by Gillian and Starks (2003), who find that the growing share ownership of institutional investors enables them to play an important role and improve corporate governance.

There are also numerous UK academic articles that describe institutional investors as active in corporate governance. The articles focus on examining the outcomes of investor activism in different areas of corporate governance. In a paper that describes ownership structures among a sample of 470 UK listed firms and the consequences of ownership on firm's control and incentive factors, Leech and Leahy (1991) establish positive effects of large institutional shareholdings on corporate control and performance. While surveying the voting levels of the Top 250 UK firms, Mallin (1994) finds that the mean level of voting was 35%. That, however, changed and voting levels have gradually increased to around 65% (Mallin, 2010). Furthermore, while investigating the monitoring role of UK shareholder coalitions, Crespi and Renneboog (2010) provide evidence of voting coalitions in the UK. Crespi and Renneboog find that voting power held by financial institutions (mainly the insurance companies) is positively related to executive director turnover. Their paper shows that voting coalition of shareholders can be instrumental in bringing about change in poorly performing companies.

Besides corporate performance, there is also evidence of UK institutional investors concerning themselves with other areas of corporate governance. In a paper that explores how investment fund managers deal with information uncertainty in stock selection and asset allocation decisions, Holland (2006) suggests that UK investors concern themselves with board structure, the extent of a board's power over top management, the ability of a board to show unity of direction and purpose, the stability of senior management, succession policy, the separation of Chairman and Chief Executive roles, and the number and quality of Non-Executive directors. Holland's (2006) data set consisted of interviews with 40 investment fund managers conducted between 1997 and 2000. Furthermore, while exploring the differences between institutional investors in the UK and the US concerning corporate social responsibility (CSR), Aguilera, et. al. (2006) find that institutional investors in the UK show a significant increase in the level of involvement with their investee companies, concerning themselves with corporate governance issues such as corporate strategy, board effectiveness, executive remuneration and succession planning. The reasons for this are said to include the governmental pressure for active ownership, with impetus from the Myners Review (2001) and the Combined Code (2006), as well as the tendency of institutional investors in the UK to hold shares for a relatively longer period of time than in the US (Aguilera, et. al. 2006). [Is this really significant? How much longer?]

With particular reference to compensation, Dong and Ozkan (2008) empirically examine the determinants of directors' pay for a sample of listed, non-financial UK firms, focusing on institutional investor ownership. Dong and Ozkan find that long-term oriented investors restrain the level of directors' pay and strengthen the link between pay and performance. Dong and Ozkan also note that the findings of their study are consistent with their expectations that the long-horizon institutional investors are more involved in corporate governance and serve a better monitoring and disciplining role in corporate governance.

A number of UK studies also indicate that institutional investors effectively monitor their investee companies. While investigating the investment cash flow sensitivity of 985 firms listed on the London Stock Exchange (LSE) between 1992 and 1998, Pawlina and Renneboog (2005) suggest that institutional investors appear to play a part in mitigating information asymmetries between capital markets and firms by effective monitoring. In addition, in a book that examines the relations between investors and firms, Martin, et. al. (2007) show that institutional investors such as UK fund managers routinely analyse information concerning those companies in which they invest, vote and have meetings with company senior management. Investors also might propose resolutions, resort to calling extraordinary general meetings and intervene jointly with other shareholders. Comparative studies between UK and US on shareholder activism by Noe, (2002) suggest that within current financial market structures investors have the ability not only to monitor their companies effectively, but also profitably. Noe argues that strategic investors (those that are capable of intervening in corporate governance) can monitor and intervene in the firm's management, while investors with small holdings appear to take up investor activism more aggressively. Noe concludes by suggesting that there is no monolithic relationship between the size of shareholdings and activism. Leech (2002) echoes Noe's (2002) conclusion by arguing that the minority shareholders can be almost as powerful as the majority shareholders.

Corporate Social Responsibility and Shareholder Engagement

Broadly, Corporate Social Responsibility (CSR) is about corporate entities acting as good corporate citizens. However, this seemingly straightforward term CSR over time has acquired different meanings to different organisations and individuals. William C. Frederick provided one of the earlier definitions of CSR as he wrote:

> *[Social responsibilities] mean that businessmen should oversee the operation of an economic system that fulfils the expectations of the public.*

And this means in turn that the economy's means of production should be employed in such a way that production and distribution should enhance total socio-economic welfare. Social responsibility in the final analysis implies a public posture toward society's economic and human resources and a willingness to see that those resources are used for broad social ends and not simply for the narrowly circumscribed interests of private persons and firms. (Frederick, 1960, p. 60)

With the growth of institutional investment in the UK, we have also witnessed an increasing awareness of socially responsible investment (SRI), which has become an integral part of corporate governance at the individual company level, as well as at the institutional investment level. As institutional investors are becoming more aware of the importance of CSR, there is also a growing body of academic literature that highlights increasing activity of institutional investors to promote corporate, social and environmental responsibility. Armour et. al. (2003) suggest that some institutional investors in the UK are beginning to redirect their investment strategies in favour of longer-term, stakeholder-inclusive practices. Another study, which assesses 1146 ethical investors and their willingness to support active ethical investment in the UK by Lewis and Mackenzie (2000), finds that institutional investors generally supportethical investment practices. Lewis and Mackenzie indicate that investors are willing to engage in a dialogue with investee companies to improve corporate practices. In addition, while discussing whether it pays to invest ethically and examining corporate social responsibility from philosophical, moral and practical point of view, Hellsten and Mallin (2006) acknowledge the growth of ethical investment funds in the UK. Hellsten and Mallin suggest that ethical investing has an important role to play in reinforcing corporate and social responsibility.

A UK survey on institutional socially responsible investment (SRI) carried out by Dresner (2002) indicates that 95 % of fund managers become involved with the investee companies in the issues arising from SRI. Dresner also finds that investors prefer to negotiate with investee companies individually, where only 6% of activism is collaborative, namely, where groups of investors come together to influence one or more target companies. While exploring how corporate activism by socially responsible investors could enhance stakeholder accountability, McLaren (2004) argues that corporate, social and environmental abuses result from the lack of corporate accountability. Furthermore, in an empirical investigation of the patterns of UK shareholdings and its relationship with socially responsible behaviour by companies within a sample of over 500 UK firms, Cox, et. al. (2004) find that long-term institutional investing is positively related to corporate social performance and that long-term institutional investors reject those firms that have the worst corporate social performance indicators. In a review of the growth of the socially responsible investment in the UK and Japan, Solomon, et. al. (2004) indicate that SRI is more mature in the UK and that one of the reasons for this is the positive impact of the dialogue between institutional investors and corporate managers. Solomon, et. al. (2004) note that in 2001 institutional investors in the UK invested EUR 5910 million into socially responsible investment funds. In seeking to explain UK institutional investors' motives to care about CSR, Aguilera, et. al. (2006) put forward instrumental (self-driven), relational (group-oriented and legitimising) and moral (appropriate behaviour) motives, exemplifying the CSR activities of the Universities Superannuation Scheme (USS).

More recently, Hawley and Williams (2007), Thamotheram and Wildsmith (2007) Lyndenberg (2007) emphasise a growing academic interest in institutional investors playing an active role in corporate governance and SRI as 'Universal Owners' whose investment behaviour is different in that it deliberately takes account of more than market price in seeking returns on investment (Lyndenberg, 2007). In a review of the evolution of UK institutional investors' interest in climate change from 1995 to 2005, Pfeifer and Sullivan (2007) demonstrate that institutional investors, particularly pension funds, begin to concentrate not only on issues of corporate governance, but also on corporate ethical and social responsibility. Pfeifer and Sullivan conclude that 'soft' policy measures such as information disclosure and awareness-raising played an important role in encouraging institutional investors to discuss social and environmental issues with corporate managers. The introduction of 'hard' policy measures such as regulation and market-based instruments had led to investors systematically factoring issues such as climate change into their investment analysis. The latest [2010? Has nothing else been published?]discussion on the forms and effects of shareholder activism by Chung and Talaulicar (2010) confirms that investor engagement is on the increase.

Shareholder Disengagement

Paradoxically, Davis (2008) and Jackson (2008) observe that although institutional investors seem to be increasing in both size and the concentration of their stakes, this concentrated ownership is generally liquid and without commitment, focusing on generating short-term investment returns. This is reflected in the trend towards increased stock turnover and shorter average stock-holding periods (Tomorrow's Owners, 2008; Ownership Commission, 2012). For example, in the UK institutional investors' portfolio turnover reached 56% (Jackson, 2008), while the average duration of equity holding has fallen from five years in the 1960s to just over seven months in 2009 (Haldane, 2010).

The language of investor 'passivity' and disengagement goes back to Berle and Means (1932) and has been used by scholars such as Bernard Black (1990; 1992) and John Coffee (1991). More recently, it was reiterated by Paul Myners, who claimed that investors were *'too passive, just accepting the decision management make...'* (Hawthorne, 2009, p. 12). Like the evidence on shareholder activism, the literature on investor passivity can be found both in the UK and the US context.

In the US, a number of studies on investor activism suggest that there is little link between activism and performance. One of the significant overviews of institutional investors and shareholder activism is carried out by Gillian and Starks (1998). In their survey of empirical and theoretical research regarding motivations and outcomes of shareholder activism, the two authors find mixed empirical evidence of shareholder activism. Although Gillian and Starks' paper finds some short-term market reaction to some forms of activism, there is little to indicate a link between activism and performance. Similarly, in a survey of empirical findings of the impact of shareholder activism on target companies, Karpoff (2001) indicates a disagreement within the literature over the extent to which shareholder activism facilitates improvement in target firms and concludes that shareholder activism has negligible impact on share value and earnings. Furthermore, the investigation of the impact of Focus Listing by the Council of Institutional Investors on targeting poorly performing companies by Song and Szewczyk (2003) finds very little evidence of the effectiveness of coordinated shareholder activism. Song and Szewczyk analyse the holdings of banks, insurance and investment companies, investment advisors, pension funds and university endowment funds, finding no evidence that shareholder activism via Focus List is an effective device to enhance a firm's value.

Other studies cast doubt on the significance of institutional investors in affecting corporate governance. While examining the data on the determinants of institutional ownership, Edwards and Hubbard (2000) doubt that institutional investors are likely to alter significantly the way U.S. corporations are run, despite the increase in institutional stock ownership that has occurred since 1980. Edwards and Hubbard argue that the optimism about the prospects of corporate governance revolution led by a growth of institutional investors might be premature because apart from the episodic activities of a few large pension funds, institutional investors have not taken an active role in corporate governance. Edwards and Hubbard (2000) suggest that one of the reasons for this might be that although institutional ownership increased since the 1980s, it is generally still quite low and unlikely to reach the concentration that would allow investors to have a voice in the boardroom. Investors also face significant legal and institutional constraints that deter them from accumulating large ownership stakes and use those stakes to discipline managers. Another US study that examines the nature of hedge fund activism and its effects on corporate governance and control by Kahan and Rock (2007) highlights that traditional institutional investors do not pursue activism because of their investment diversification strategies.

Within the UK, a number of studies examine investor activism in the context of voting. In an international comparison of institutional investors' voting practices, Mallin (2001) argues that although institutional investors have the potential to exert significant influence on corporations using their voting rights, the levels of institutional voting are much lower in the UK than was expected, amounting to just over 46% in 1998 for FTSE 350 companies. Mallin suggests that the existing proxy voting system in the UK is viewed as slow and over-complicated, with many players along the chain, limiting flexibility. Mallin concludes by summarising that the institutional investors' voting levels are disappointing and that there is still a long way to go to achieve the type of institutional investor envisaged in the Myners Report (2001). Similarly, in a book *Control of Corporate Europe* Goergen and Renneboog (2002) note that institutional investors are the most important category of UK shareholders. However Goergen and Renneboog argue that institutional investors tend to be passive corporate owners who often fail to exercise their voting rights. According to Goergen and Renneboog, the passive stance of investors increases the already significant power of corporate directors who represent the second most important category of investors, creating agency problems of high managerial discretion. More recently, Conyon and Sadler (2010) find that less than 10% of UK shareholders vote against the mandated Directors' Remuneration Report resolutions, which means that on average, 'say on pay' does not materially alter the subsequent level and design of CEO compensation.

When it comes to investor monitoring and intervening in poor corporate performance, Franks, et. al. (2001) find little relation between poor performance and concentration of institutional investor ownership. While examining a randomly selected sample of 250 companies quoted on the London Stock Exchange between 1988-1993, combined with the information on stock ownership, sales of share blocks, takeovers, board and capital structures, Franks, et. al. (2001) indicate that holders of large share blocks exert little disciplining influence on corporate management. Furthermore, in their analysis of CEO turnover and monetary remuneration schemes within 250 UK listed companies, Renneboog and Trojanovski (2003) reveal little evidence of outside shareholder monitoring to mitigate agency problems between managers and shareholders. Renneboog and Trojanovski find that CEOs with strong voting power successfully resist replacement, irrespective of corporate performance, concluding that powerful outside shareholders do not seem to be interested in removing CEOs even in the light of poor corporate performance. In the discussion of the problems and limitation of investor participation in corporate governance, Webb, et. al. (2003) utilize the academic literature on financial system design to question the viability of institutional investors assuming an active role in monitoring and disciplining managers in the UK. Webb, et. al. highlight that there has been, and there will remain, a dearth of solid incentives for institutional investors to involve themselves more systematically in corporate governance matters, and that fund managers may be doing their best by remaining passive. Webb, et. al. (2003) argue that it is inappropriate to expect institutional investors to behave like banks and have long-term relationships with companies because institutional investors have different constraints, investment time horizons and abilities.

In the empirical investigation of eight institutional investors and the overall role of investors as owners of public companies, Hellman (2005) argues that institutional investors are passive because they are not well suited to affect the way companies are managed. Hellman suggests that investors tend to simplify the information available to them regarding listed companies and rely too much on external advice, which might have negative implications for the management of the listed companies. Hellman (2005) concludes by saying that even the large institutional investors cannot assume responsibility for corporate governance processes because these organisations are not designed to develop profound knowledge about specific investee companies to have a genuine contribution to the discussions about corporate strategy with the management.

In the context of investment practices of UK pension funds, Tilba and McNulty (2013) provide further support for investor disengagement, finding the majority of pension funds to be distant and more concerned with the performance of the portfolios of their investment managers, rather than the performance of individual companies in which they hold shares. Although one might expect pension funds to act as long-term and engaged share owners because of their supposedly long-term investment horizons (Ryan and Schneider, 2002), Tilba and McNulty (2013) found that pension funds do not seek to influence their investee companies because they operate at a considerable distance from their investee corporations, with a high dependency on a chain of financial market intermediaries. Most recently Tilba and Wilson (2017) cast doubt on the willingness and ability of pension funds to change their disengaged behaviour because participants seem to decouple their view of the world from their impact on the world.

Conclusions

Over the past twenty-five years, we have witnessed an endless flow of corporate scandals accompanied by criticisms of financial markets and indeed the nature of ‘capitalism’ itself. While governance codes of best practice have been evolving since Cadbury 1992, there is still very little to show for all this activity. Arad Reisberg (2015) has rightfully described the UK Stewardship Code as ‘trivial, absent of meaning and incapable of achieving its goals’. Such critique is not surprising. While the UK has long been seen as a global leader in corporate governance reform and the development of voluntary codes and guidance of best practice, we still find ourselves in a paradox of ‘ownerless companies’ with broken chains of accountability (Tilba and McNulty, 2013) and compliance, with the codes of best practice seemingly to be more assumed than demonstrated. It is unclear whether or not the signatories to the codes of best practice translate their commitment into action. The poor quality of explanations of non-compliance to date is indicative of the ineffectiveness of these codes (Reisberg, 2015). Although a number of scholars have argued that the so-called ‘new era’ of capitalism ought to be characterised by institutional investors (particularly pension funds) acting as share ‘owners’, the existing evidence of institutional investor distance and investment short-termism indicates that the reality of business ownership and control is more consistent with the prevalence of control by managers rather than institutional owners (Tilba and Wilson, 2017). The authors find the focus on shareholder value and the role of shareholders, with many attempts made to facilitate further engagement and stewardship between shareholders and management within academic and policy debates misconceived because trustees’ accounts of their fiduciary role within the trust relationship contradict in practice the logic of engagement, as many trustees equate beneficiaries’ interests to *financial* interests and maximizing investment returns.

The UK’s policy makers and legislators continue to promote the principles of fairness, transparency and accountability through various industry consultations and reports. The most recent year-long Asset Management Market Study (2016/2017) by the UK Financial Conduct Authority has looked into the effectiveness of the UK’s asset management and financial services industry. The consultation found that the industry is not working in the consumer’s best interests due to weak price competition, lack of transparency and accountability within asset management, with no clear relationship between investment charges and investment performance. The key proposed remedies included better protection for investors; clearer understanding of what value for money looks like and how to achieve it; strengthening the duty of fund managers to act in the best interest of their clients; and better disclosure.

So far, the report has received a mixed reception within the finical services industry – some find the Report to be progressive and robust in its assessment and recommendations, yet others found it disappointing and not going far enough. Questions were asked about FCA’s ability to monitor and enforce their proposed remedies, while some concerns were raised about the lack of focus on education of individual investors within the Report (Transparency Symposium, July 2017).

Notwithstanding this pessimistic perspective, it is worth concluding on a positive note. Corporate governance, corporate social responsibility and engaged responsible investor behaviour can help strengthen the economy and improve not only the lives of corporate and investment managers, but also the lives of various stakeholders. Corporate governance reforms and the development of codes of best practice continue to grow and are unlikely to lose their public and policy attention. New challenges will no doubt emerge and the governance structures will evolve to adapt in light of these challenges. However, another important part of the solution should also lay with the individual. Accountable and responsible corporate behaviour can only be achieved by accountable and responsible behaviour of individuals within firms. Ultimately, (over)regulation should not replace the professionalism of individuals and boards as a collective of individuals acting with integrity.

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